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Hyman P. Minsky Ph.D.

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By HYMAN P. MINSKY

A smug attitude about the strength and resilience of the financial structure following the apparent resolution of the Hunt/Bache silver episode without a catastrophe: David Gartner of the Commodity Futures Trading Commission called what happened "free enterprise at its finest hour".

Such accolades are not warranted. The crash of the silver market revealed that funds are available for large deals which violate basic canons of prudent finance and that when these deals unravel the viability of financial markets and institutions can be endangered.

The financial structure has become increasingly convoluted. Household and business debts are much greater even as banks and other financial institutions use liabilities that are both expensive and volatile to finance positions in assets with substantial market risks. The current collapse of the long-term bond and mortgage markets is accentuating the trend toward the use of short-term and volatile debts.

Dr. Minsky is professor of economics at Washington University, St. Louis.

Even where operations yield substantial cash flows, financial arrangements now involve more rolling over of debt than would have been deemed prudent just a few years (or months) ago. Independent of the use of credit to finance speculations, the financial structure is much more fragile than it was earlier in the post-war era. Hunt/Bache showed that the unraveling of speculation can be the trigger for a cumulative debt-deflation. Fortunately as yet that has not taken place.

In our economy borrowing and lending takes place on the basis of margins of safety. For well structured loans the value added in the borrower's operations are expected to be more than sufficient to meet payment commitments. Interest payments are an appointment of value added. In arrangements such as Hunt/Bache the asset is inert; it does not generate value added. In such cases interest, as it accrues, increases the outstanding debt.

This accrued interest is income to the lender, which can finance spending. Spending financed by such accruals is inflationary. Furthermore, because the accruals increase total debts, they lead to upward pressure on interest rates.

Debt will be available to finance the holding of inert assets only if the expected rate of appreciation of the asset is greater by some margin than the interest rate. However, a speculative boom increases the demand for credit which puts upward pressure on interest rates. It leads to interest rates that approach the expected rate of appreciation of the asset. When this happens the margin of safety evaporates and so does the availability of credit. A speculative boom is a self-limiting process.

Any banker knows that if debts can be paid only if assets are sold, then the assets owned must be a small portion of an active market, for only then can the position be liquidated without moving the market.

Thus, two canons of prudent finance — that speculative booms are self-limiting and that positions must be saleable — were violated in the Hunt/Bache affair. That this

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could happen is a basis for apprehension. Somebody is not minding the store.

Thin margin financing of land held for development is financially equivalent to the Hunt deal, once the pace of development slows. Institutions deeply involved in such financing are likely to be "problems" in the coming months.

The present taut financial posture is the fourth crisis-prone situation since 1966. The prior episodes were the credit crunch of 1966, the liquidity squeeze of 1970 and the debacles of 1974/75. This history shows that since the mid-1960s the normal functioning of our economy periodically pushes it to the brink of a financial crisis.

Going to and even past a brink doesn't mean that a "free fall" into a full-fledged depression will follow. There are safety nets. Lender-of-last resort interventions by the Federal Reserve and the cooperating public and private institutions prevent a "free fall". In the Hunt/Bache affair the "safety net" apparently consisted of (1) the acceptance by creditors of assets in lieu of each, (2) the availability funds to finance these creditors, and (3) intervention by authorities which effectively put a floor to silver prices.

If the events of March qualify as a "finest hour", it might very well be for "central banks" not for "free enterprise".

When the problems of the Franklin National Bank became evident, Federal Reserve loans provided funds which enabled Franklin National to honor maturing debts, Furthermore, the Federal Reserve stood ready to "discount" without limit if necessary to prevent a "panic". This lender-of-last-resort response and a massive Federal deficit made the 1974/75 recession short and mild.

Aid to Inflation

These interventions also assured that inflation, which the recession decreased, would be even faster within several years. Today's inflation is largely a delayed response to the policy moves of 1974/75.

The policy actions of 1974/75 really mattered in that the course of the economy over the past five years was largely determined by what was done at that time. We are now in another period in which policy matters. What the Federal Reserve does as a lender of last resort, the course of federal spending and taxing and the reactions to exchange rate pressures over the rest of this year are likely to determine the course of the economy over the next five years.

Because each financial crisis is unique, policy is a mixed game of chance and skill. Because of the many dimensions of today's apparent financial weakness, chance looms larger than hitherto in determining the effect of policy initiatives. Mechanistic policy, guided by simplistic slogans such as "money only matters", "balance the budget", "deregulation" or "supply side" and unenlightened by insights into the complexity of institutions and usages, is likely to make things worse, not better.

For the pure science of economics, 1980 will be a critical experiment that should teach us much about the behavior of capitalism under stress. For those who will live in the 1980s both likely outcomes to today's inflation — accelerating inflation after a brief respite or a severe and prolonged recession — are unsatisfactory.

Thorough structural reforms, which reflect an awareness of the instability of our economy, are necessary. Unfortunately, such reforms are not now on the agenda.